

REPORT OF EXAMINATION
OF THE
RESIDENCE MUTUAL INSURANCE COMPANY

AS OF
DECEMBER 31, 2006

Participating State
and Zone:

California

Filed May 27, 2008

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Los Angeles, California
May 15, 2008

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Morris Chavez
Secretary, Zone IV-Western
Superintendent of Insurance
New Mexico Insurance Division
Santa Fe, New Mexico

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman, Secretary, and Commissioner:

Pursuant to your instructions, an examination was made of the

RESIDENCE MUTUAL INSURANCE COMPANY

(hereinafter also referred to as the Company) at the primary location of its books and records, 27489 Agoura Road, Agoura Hills, California 91301.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2003. This examination covers the period from January 1, 2004 through December 31, 2006. The examination was made pursuant to the National Association of Insurance Commissioners' plan of examination. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2006, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: company

history; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; accounts and records and sales and advertising.

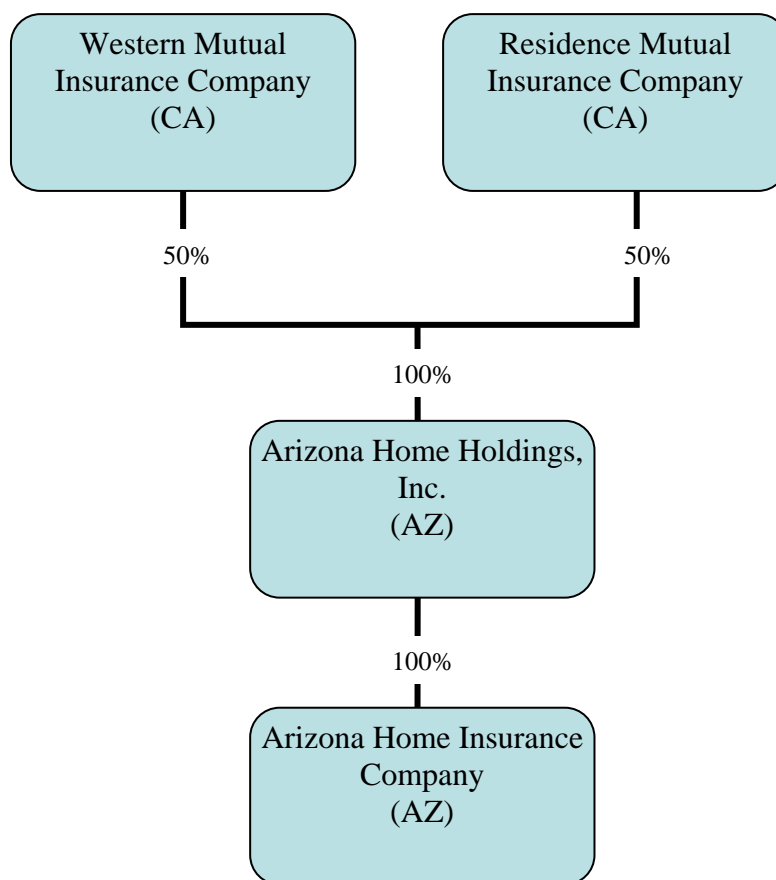
This examination was conducted concurrently with the examination of the Company's affiliate, Western Mutual Insurance Company.

SUBSEQUENT EVENTS

On September 12, 2007, the Company purchased an office building located in Irvine, California for \$4.275 million. The Company intends to relocate its Irvine office in 2008 and occupy approximately 50% of the building.

MANAGEMENT AND CONTROL

Both of the Companies in the Group are mutual companies and therefore they are not part of a holding company system. The Companies each own a 50% share of the following companies:



Management of the Company is vested in a five-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2006 follows:

Directors

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Michael D. Antonovich Glendale, California	Los Angeles County Supervisor
John J. Barcal La Habra Heights, California	Attorney John J. Barcal, Inc.
Catherine Berryman Poway, California	Private Investor
Joe Crail	Chairman of the Board and President

Name and Residence

Pacific Palisades, California

Lucile Ann Crail
Silverton, OregonPrincipal Business AffiliationWestern Mutual Insurance Company,
Residence Mutual Insurance and Arizona
Home Insurance Company

Private Investor

Principal OfficersNameTitleJoe Crail
Paul R. Ruincam(*)President and Chief Executive Officer
Senior Vice President of Underwriting and
Regulatory, Secretary and Treasurer
Vice President and Chief Financial Officer
Senior Vice President of Claims
Senior Vice President of SystemsPaul J. Shen
Daniel C. Greulich
Paul E. Calvet

(*) retired effective January 1, 2008

Insurance Holding Company Registration (Form B) Statement

The Company and its affiliate, Western Mutual Insurance Company (WMIC), are mutual insurance companies and as such have no shareholders or issued securities. In addition, the Company is not part of a holding company system, although it has operated under a quota share affiliated pooling agreement since 1985. In May 1998, in response to the Company's request to modify its pooling agreement, the California Department of Insurance (CDI) required the Company and WMIC to annually file a Registration Statement (Form B) under the Insurance Holding Company Act.

Business Arrangements Between the Company and its President

A review of transactions and business arrangements between the Company and companies owned in whole or in part by the Company's Chairman of the Board and President, Mr. Joe Crail, disclosed the following:

Cardinal Broadway Properties: Mr. Crail is the sole shareholder of Cardinal Broadway Properties (CBP). CPB is a licensed agent for the Company with a dba of Cardinal Insurance Agency (CIA). Approximately two percent (2%) of the Company's written premiums are produced through CIA. Premiums written through CIA for the years 2004, 2005, and 2006 were \$537,569, \$518,921, and \$444,946, respectively. Commissions paid to CIA for the years 2004, 2005, and 2006 amounted to \$157,226, \$147,601, and \$135,872, respectively.

California Insurance Code (CIC) Section 1101 requires that an admitted insurer's officers, directors, trustees and any persons who have authority in the management of the insurer's funds, shall not, unless otherwise provided in the code (1) receive any money or valuable thing for negotiating, procuring, recommending or aiding in, any purchase by or sale to such insurer of any property, or any loan from such insurer, (2) be pecuniarily interested as principal, co-principal, agent, attorney or beneficiary, in any such purchase, sale or loan, and (3) directly or indirectly purchase, or be interested in the purchase of, any of the assets of the insurer. The Company may obtain a certificate of exemption prior to consummation of a transaction falling within CIC Section 1101.

The Company and WMIC filed an application for a Certificate of Exemption from CIC Section 1101 with the CDI related to the previously discussed contractual agreement between the Company, WMIC and Cardinal Insurance Agency (CIA). The exemption certificate was issued by the CDI on April 7, 2006.

Management Agreements

Service Agreement: Effective January 1, 2006, the Company, Western Mutual Insurance Company (WMIC), and Arizona Home Insurance Company (AHIC) entered into a service agreement whereby the parties cooperate in the performance of certain administrative and special services and share in the use of the day to day operations of certain property, equipment, and facilities of the group (group being all three companies). The majority of the shared functions are provided by WMIC including: accounting and auditing, premium collection, underwriting, claims, actuarial, data processing, legal, and payroll. The costs of the services are allocated at cost in accordance with the pooling percentages; 53% to the Company, 12% to AHIC and 35% to WMIC. The agreement requires that charges be settled within 30 days after each quarter, however the companies are settling on a monthly basis. The total cost of the services covered under the agreement during 2006 was \$5,814,292, of which \$3,172,402 was allocated to the Company. The CDI approved this agreement on February 8, 2008.

CORPORATE RECORDS

The Company's bylaws state that its business and affairs shall be managed by a board of directors consisting of six (6) directors. The Company's board consisted of five (5) directors as of December 31, 2006. On April 21, 2008, the Company elected a sixth member to the board of directors and is now in compliance with its bylaws.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2006, the Company was licensed to write fire, disability, plate glass, liability, and miscellaneous coverage in California, Colorado, Nevada, New Mexico, Texas, and Utah. The Company only wrote business in the State of California. In 2006, the Company wrote \$41.1 million of direct premiums.

Policies are issued exclusively on residential properties. Business is produced on a direct basis as well as through approximately ten agencies and several hundred brokers.

On September 12, 2007, the Company purchased an office building located in Irvine, California for \$4.275 million. The Company intends to relocate its Irvine office in 2008 and occupy approximately 50% of the building.

REINSURANCE

Intercompany Pooling Agreement

The Company participates in an Intercompany Pooling Agreement (Agreement) with Western Mutual Insurance Company (WMIC) and Arizona Home Insurance Company (AHIC). Effective January 1, 2006, the Agreement was amended to include Arizona Home Insurance Company and amend the pooling participations. The Company's new participation in the pool is 53%, WMIC's participation is 35% and AHIC's participation is 12%. Under the terms of the Agreement, all the premiums written by the Company and AHIC are ceded to and pooled with those written by WMIC. The combined premiums, net of cessions pertaining to all other reinsurance agreements, are ceded back to the Company. Losses, loss adjustment expenses, and underwriting expenses are also combined and pooled in the same percentages. The amended pooling agreement was approved by the California Department of Insurance on December 27, 2007.

Assumed

Other than business assumed under the terms of the intercompany pooling agreement, the Company does not assume any business.

Ceded

The Company cedes various risks to other insurance companies. The largest net amount retained by the Company, WMIC and AHIC on one loss is \$250,000. At December 31, 2006, the Company maintained the following reinsurance agreements:

Type of Contract	Reinsurer's Name	Company's Retention	Reinsurer's Maximum Limits
Excess of Loss			
First Property & Casualty Excess Per Risk	100.00% Motor Insurance Corp.	\$250,000	\$250,000 each risk \$750,000 maximum per occurrence
Second Property & Casualty Excess Per Risk	100.00% Motor Insurance Corp.	\$500,000	\$500,000 each risk \$1 million maximum per occurrence
Third Property & Casualty Excess Per Risk	100.00% Motor Insurance Corp.	\$1,000,000	\$1 million each risk \$2 million maximum per occurrence
Excess Catastrophe			
First Layer	69.00% JLT Reinsurance 10.00% AXA Reinsurance 5.00% Lansforsakringar 5.00% Mapfre Re Compania 5.00% XL Reinsurance Ltd. 4.00% American Agricultural 2.00% Sirius International	\$2.5 million	95% of \$2.5 million each occurrence
Second Layer	65.00% JLT Reinsurance 10.00% AXA Reinsurance 6.00% Sirius International 5.00% Lansforsakringar 5.00% Mapfre Re Compania 5.00% XL Reinsurance Ltd. 4.00% American Agricultural	\$5 million	95% of \$5 million each occurrence
Third Layer	70.00% JLT Reinsurance 10.00% AXA Reinsurance 6.00% Sirius International 5.00% Lansforsakringar 5.00% Mapfre Re Compania	\$10 million	95% of \$10 million each occurrence

Type of Contract	Reinsurer's Name	Company's Retention	Reinsurer's Maximum Limits
	4.00% American Agricultural		
Fourth Layer	66.00% JLT Reinsurance 10.00% AXA Reinsurance 5.00% Lansforsakringar 5.00% Mapfre Re Compania 5.00% Sirius International 5.00% XL Reinsurance Ltd. 4.00% American Agricultural	\$20 million	95% of \$25 million each occurrence

As of December 31, 2006, reinsurance recoverables for all ceded reinsurance totaled \$7.3 million, or 22.83% of surplus as regards policyholders. Approximately \$6.6 million are recoverables resulting from the Intercompany Pooling Agreement. The remaining \$700,000 of reinsurance recoverables are from non-affiliated admitted reinsurers.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2006

Underwriting and Investment Exhibit for the Year Ended December 31, 2006

Reconciliation of Surplus as Regards Policyholders
from December 31, 2003 through December 31, 2006

Statement of Financial Condition
as of December 31, 2006

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 45,517,752	\$	\$ 45,517,752	
Stocks:				
Common stocks	7,299,810		7,299,810	
Cash and short-term investments	5,447,676		5,447,676	
Investment income due and accrued	652,274		652,274	
Uncollected premiums and agents' balances in course of collection	1,474,690	3,049	1,471,641	
Amounts recoverable from reinsurers	1,961		1,961	
Net deferred tax asset	1,098,000		1,098,000	
Electronic data processing equipment and software	142,923	142,923		
Furniture and equipment	3,635	3,635		
Aggregate write-ins for other than invested assets	<u>331,265</u>	<u>32,760</u>	<u>298,505</u>	
Total assets	<u>\$ 61,969,986</u>	<u>\$ 182,367</u>	<u>\$ 61,787,619</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 6,855,045	(1)
Loss adjustment expenses			2,665,900	(1)
Commissions payable, contingent and other similar charges			1,854,544	
Other expenses			1,227,568	
Taxes, licenses and fees			9,549	
Federal and foreign income taxes			545,000	
Unearned premiums			16,460,385	
Ceded reinsurance premiums payable			<u>89,467</u>	
Total liabilities			29,707,458	
Unassigned funds (surplus)		<u>\$ 32,080,161</u>		
Surplus as regards policyholders			<u>32,080,161</u>	
Total liabilities, surplus and other funds			<u>\$ 61,787,619</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2006

Statement of Income

Underwriting Income

Premiums earned		\$ 27,688,263
Deductions:		
Losses incurred	\$ 7,992,526	
Loss expense incurred	3,562,450	
Other underwriting expenses incurred	<u>10,075,160</u>	
Total underwriting deductions		<u>21,630,136</u>
Net underwriting gain		6,058,127

Investment Income

Net investment income earned	\$ 2,130,539	
Net realized capital gains	<u>1,352,786</u>	
Net investment gain		3,483,325

Other Income

Finance and service charges not included in premiums	<u>\$ 160,163</u>	
Total other income		<u>160,163</u>
Net income before federal income taxes		9,701,615
Federal income taxes incurred		<u>2,970,911</u>
Net income		<u>\$ 6,730,704</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2005		\$ 26,382,233
Net income	\$ 6,730,704	
Change in net unrealized capital losses	(1,247,958)	
Change in deferred income tax	266,000	
Change in nonadmitted assets	<u>(50,818)</u>	
Change in surplus as regards policyholders		<u>5,697,928</u>
Surplus as regards policyholders, December 31, 2006		<u>\$ 32,080,161</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2003 through December 31, 2006

Surplus as regards policyholders, December 31, 2003, per Examination			\$ 17,884,076
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net gain	\$14,459,834	\$	
Change in unrealized capital losses		337,767	
Change in deferred income tax	203,000		
Change in nonadmitted assets	<u> </u>	<u>128,982</u>	
Totals	<u>\$ 14,662,834</u>	<u>\$ 466,749</u>	
Net increase in surplus as regards policyholders for the examination			<u>14,196,085</u>
Surplus as regards policyholders, December 31, 2006, per Examination			<u>\$ 32,080,161</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

Based upon a review conducted by a Casualty Actuary from the California Department of Insurance, the Company's reserves for losses and loss adjustment expenses as of December 31, 2006, were found to be reasonably stated and have been accepted for the purposes of this examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

None.

Previous Report of Examination

Accounts and Records (Page 7): A review of the Company's general controls over its information systems noted several weaknesses in areas such as information security and disaster recovery. The Company has instituted procedures to strengthen controls over its information security and disaster recovery.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

/S/

Constance J. Korte, CFE
Examiner-In-Charge
Department of Insurance
State of California